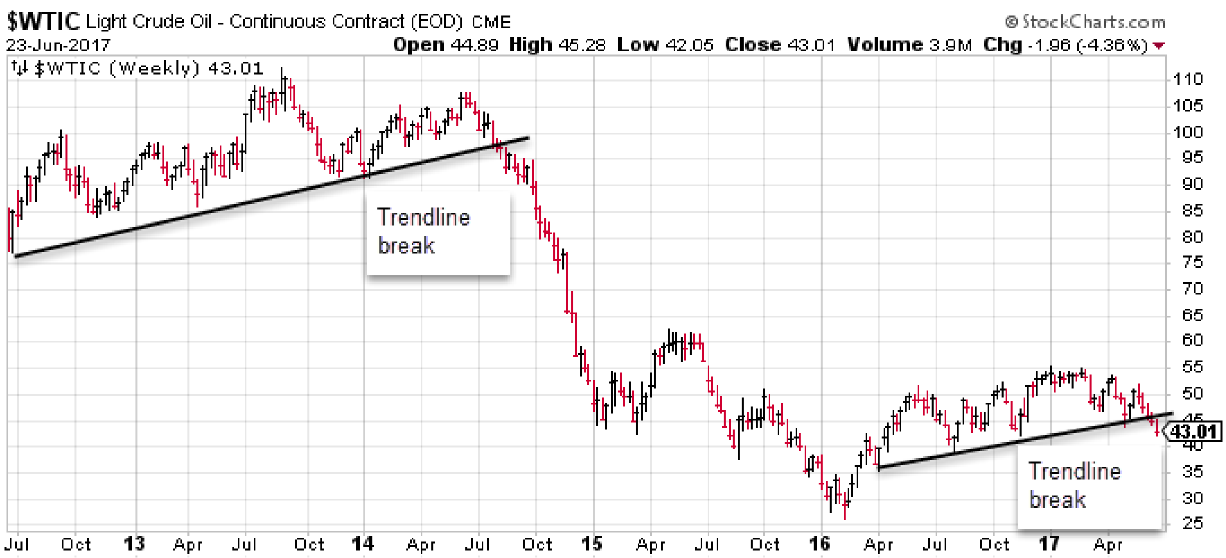
Philequity Corner (June 26, 2017)
By Wilson Sy

Bear Market in Crude Oil

Oil is technically back in bear market territory. US light sweet crude fell 22 percent to $43.01 per barrel last week from a high of $55.24 per barrel at the start of the year. The inability of oil prices to go past $55 per barrel and its recent collapse show that the supply and demand dynamics has changed in recent years. Both technical and fundamental factors indicate that oil prices will stay at low levels in the future.

Note that crude oil has plunged 76% from a high of $110 per barrel in 2013 to a low of $26 per barrel in 2016. During the 2008 Global Financial Crisis, crude oil fell 79% from a peak of $145 per barrel in July 2008 to a low of $30 per barrel by December 2008.



Source: Stockcharts.com, Wealth Securities Research

Supply-demand imbalance

The recent report from International Energy Agency (IEA) shows that there is too much supply in the crude oil market while demand remains weak. IEA forecasts that US and non-OPEC output will grow by 1.5 million barrels per day in 2018, outpacing global demand growth of 1.4 million barrels a day in 2018. Despite the global economy regaining some traction, too much supply vs. demand seem to suggest lower prices and a possible retest of 2016 lows.

Shale – the game changer

Global supply growth is being driven mainly by surging US production primarily from increased drilling activity in the North Dakota, Oklahoma, Permian and other shale regions. US shale drillers have put up more oil rigs as prices have recovered from 2016 lows. Moreover, advances in shale technology have enabled US shale to lower breakeven costs from $80 per barrel in 2014 down to $50 - $55 per barrel this year. In fact, some companies such as EOG and Conoco-Phillips have reportedly improved breakeven costs to under $40 per barrel at present.

OPEC has lost its oligopolistic power

OPEC's decision to cut output back in November 2016 has failed to stem the decline in oil prices as some members have not been diligent as shown by export numbers. Iraq, for example, has achieved a compliance rate of only 55 percent so far this year according to the IEA. Other OPEC members have cut production but are still selling from inventory so the amount of exports are still high. Iran, Libya and Nigeria were excluded from the OPEC agreement to slash output.

Non-OPEC countries have taken up the slack

The steady gain in US shale production, together with large supplies from Russia has countered OPEC's reduction plans, delaying the re-balancing of the oil market. Non-OPEC production is expected to grow nearly 1 million barrels per day in 2017, with projected US output growth of 600,000 barrels per day.

Hidden Caribbean stockpiles have flooded the market

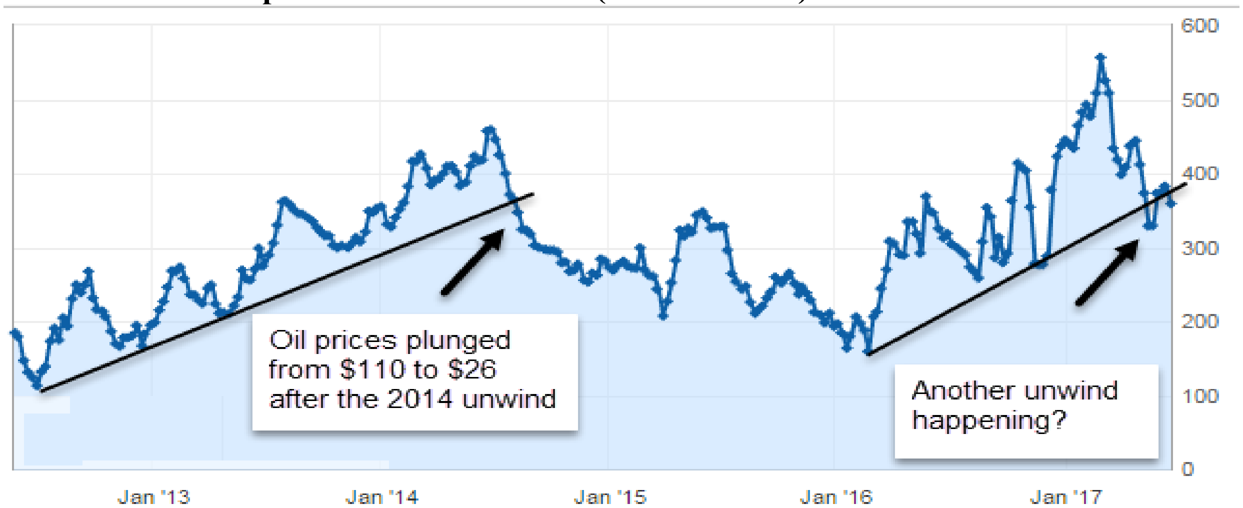
As oil prices suffered a massive dip since mid-February, the market saw hidden inventory coming out of the Caribbean. Huge oil inventory, holding as much as 140 million barrels, are being held at storage centers in the Caribbean according to a Bloomberg report back in April. As oil prices continue to fall, more of these stockpiles are expected to get drawn out, further exacerbating the oil price decline.

Chinese oil companies are reported to have leased millions of barrels of storage in the southern Caribbean Sea. According to ship-tracking data from Bloomberg, Petro China used super-tanker Nectar last March to remove stored crude from Aruba and Curacao.

Large oil speculators on the wrong side of the bet?

Looking at the other factor of the supply-demand equation, it appears that speculators have taken massive long positions in oil. The CFTC Crude Oil speculative net positions show a record high in February. Note that this was even higher than the levels back in 2014 when oil was trading above $100 per barrel.

CFTC Crude Oil Speculative Net Positions ('000 contracts)



Source: Investing.com, Wealth Securities Research

Unwinding of speculative positions

As seen from the chart above, speculators bought heavily in 2016, after OPEC agreed to cut oil production for the first time after 8 years. But despite OPEC's backing, oil prices just moved sideways from December 2016 to February 2017. By March, some speculators started pulling out their funds from their net long positions. This led oil prices to collapse below $50 per barrel. Further unwind of speculative positions similar to what happened in mid-2014 would drive oil prices down further.

Alternatives to fossil fuel

Strategic structural changes happening in the demand side means that oil now has to increasingly compete with energy alternatives. Today, cars are not only more fuel efficient, but they now run on batteries/electricity, ethanol, bio-diesel and other bio-fuels. Meanwhile, compressed natural gas (CNG) and liquefied natural gas (LNG), which are cleaner alternatives to fossil fuels, are now being used to run on buses, trucks, trains, ships and factories.

Renewable forms of energy such as solar, wind, hydro and geothermal have also been making great leaps when it comes to technological advances, making them cheaper and more efficient in recent years.

Philippines: Winner or loser?

Lower oil prices should be favorable to oil-importing countries such as the Philippines. Lower oil prices mean savings for Filipino consumers and businesses.

The Philippines had its first current account deficit in 15 years of $318 million in 1Q2017. The biggest impact came from imports of petroleum crude oil which jumped 56.4 percent or an equivalent increase of $400 million. Note oil prices were coming from a low base level in 1Q2016 which resulted in huge "base effect" increase in 1Q2017. Going forward, the decline in oil prices which started in 2Q2017 will help alleviate the current account deficit.

Oil prices are declining to multi-year lows. This may be the best time to implement the excise tax on fuel (see *Stock market cheers tax reform passage by House*, June 05, 2017). Lower oil prices is like a tax cut from the point of view of the gasoline consumers. This would reduce the impact of the excise tax on fuel and minimize its inflationary effects.

On the other hand, lower oil prices is severely damaging to economies dependent on oil exports. As a consequence, this has direct impact on the employment conditions and prospects of OFWs in the oil-rich regions such as the Middle East and North Africa which may affect OFW remittances.

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